IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA,

Petitioner,

—v.—

MACLIN P. DAVIS and EDITH U. DAVIS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

(Civil Action No. 4479)

[Caption Omitted]

DOCKET ENTRIES

June 17, 1966	Complaint filed.
June 17, 1966	Summons issued to U. S. Marshal with 6 attested copies of complaint for service on defendant. ($3.00 check payable to the Marshal delivered.)
June 21, 1966	Return on Service of Summons filed. MEF $3.00.
August 16, 1966	Answer of Defendant filed, Certificate of Service attached.
October 19, 1966	Plaintiffs' Motion for Summary Judgment, Certificate of Service attached; Brief in Support of Motion; Affidavit of Maclin P. Davis; and Affidavit of Lee Davis, filed.
November 4, 1966	Affidavit of H. Stennis Little, Jr. attorney for defendant, filed. Requested that no hearing be set on plfs' motion for summary judgment before Dec. 15, 1966 (Attested copy to U. S. Attorney) Certificate of service attached.
December 16, 1966	Filed: Discovery Deposition of Mr. Maclin P. Davis taken by defendant Dec. 1, 1966.

May 10, 1967	Cross-Motion for Summary Judgment, Affidavit of H. Stennis Little, Jr., and Brief in Support of Cross-Motion filed on behalf of defendant.
July 11, 1967	Order Entered: It is the Court's Understanding parties agree oral hearing not necessary; Plaintiffs allowed 15 days to submit supplemental brief, Defendant allowed 10 days thereafter to file reply. (Attested copy to attorneys of record)
July 24, 1967	Affidavits of Maclin P. Davis, Jr., and William Waller filed on behalf of plaintiffs, Certificate of Service (letter) attached.
July 24, 1967	Filed: Reply of Plaintiffs to Brief for the Defendants in Support of its Cross-Motion for Summary Judgment, Certificate of Service (Letter) attached.
August 4, 1967	Supplemental Memorandum for Defendant filed, Certificate of Service attached. (2 att. copies delivered to U. S. Atty)
September 15, 1967	Memorandum of the Court entered, appropriate order to be submtited within twenty days (Attested copies to attorneys of record).
October 5, 1967	Order of Judgment entered: Plaintiffs to recover $12,910.51 with 6% interest from and after Nov. 15, 1965, and costs (Certified copy delivered to the office of the U. S. Attorney; attested copies mailed to attorneys of record William Waller and H. Stennis Little, Jr.)
October 9, 1967	Motion for Rehearing filed on behalf of defendant, Certificate of Service attached.

October 19, 1967	Order Entered: Defendant's Motion for rehearing denied (Attested copy to attorneys of record).
December 1, 1967	Notice of Appeal filed on behalf of the defendant, U.S.A., certificate of service attached.
January 10, 1968	Entered: Order extending time for docketing appeal in the Court of Appeals to and including Feb. 9, 1968 (Attested copy to attorneys of record).

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

[Caption Omitted]

RELEVANT DOCKET ENTRIES

February 7, 1968	*Certified record* (1 vol. pleadings), filed; and cause docketed
December 11, 1968	Cause argued and submitted (Before: O'Sullivan, Celebrezze and McAllister, JJ.)
March 27, 1969	Judgment of the District Court affirmed
March 27, 1969	Opinion by Celebrezze, J. 8pp.
April 17, 1969	Mandate issued (No costs taxed)

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

COMPLAINT

(Filed June 17, 1966)

Statement of Jurisdiction

1. The plaintiffs bring this action against the United States of America for the recovery of income taxes for the calendar year 1963, pursuant to provisions of 28 U.S. Code Section 1346(a)(1). Plaintiffs are husband and wife and are residents of Davidson County, Tennessee. They filed their joint return for 1963 with the District Director of Internal Revenue at Nashville, Tennessee.

Statement of Claim

2. In 1945, plaintiff, Maclin P. Davis, hereafter referred to as plaintiff, purchased from Tennessee Foundry & Machine Company of which he was and is President, 1,000 shares of 6 per cent preferred stock issued by said corporation at $25 per share. Such purchase was for the purpose of fulfilling a condition precedent to the obtaining of a loan by such corporation from Reconstruction Finance Corporation. The additional capital was paid in to such corporation by the plaintiff for the particular purpose of enabling it to obtain said loan, was always intended to be temporary in nature, and was paid in with the understanding between such corporation and the plaintiff that said preferred stock would be redeemed by the corporation after said loan was paid. Said loan from Reconstruction Finance Corporation was paid in full in 1963, whereupon the corporation redeemed plaintiff's preferred stock for $25,000. Relying on Section 302 of the Internal Revenue Code, the Internal Revenue Service erroneously treated such redemption as a dividend to plaintiff and assessed additional income tax in the amount of $11,474.34, treating the proceeds of such redemption as ordinary income.

3. On or about November 15, 1965, plaintiffs paid to the District Director of Internal Revenue at Nashville, Tennessee the assessed additional income tax of $11,474.34, based on the assessment referred to in paragraph 2 hereof, plus assessed interest, or a total of $12,910.51. Plaintiffs thereafter, on or about December 7, 1965, filed a timely claim for refund, setting forth the grounds hereinabove alleged. Plaintiffs allege that said tax and interest were illegally collected and accordingly allege that they are entitled to a recovery of the aforesaid additional tax, together with assessed interest paid by them, and interest as provided by law.

Relief Prayed

4. Wherefore, plaintiffs demand judgment against the defendant for $11,474.34 overpaid on their 1963 income taxes, plus assessed interest, making a total of $12,910.51, together with interest and costs as provided by law; and plaintiffs pray for such additional relief as they may be entitled to.

WALLER, LANSDEN & DORTCH

By /s/ WILLIAM WALLER

/s/ ROBERT G. MCCULLOUGH
Partners
Attorneys for Plaintiffs
1200 American Trust Building
Nashville, Tennessee 37201

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

ANSWER

(Filed August 16, 1966)

The defendant, the United States of America, by its attorney, Gilbert S. Merritt, Jr., Esquire, United States Attorney for the Middle District of Tennessee, for its answer to the complaint, herein alleges as follows:

1. Admits the truth of all allegations contained in paragraph 1.

2. Denies the truth of all allegations contained in the last sentence of paragraph 2. The defendant is currently without information sufficient to form a belief as to the truth of all other allegations contained in paragraph 2.

3. Denies the truth of all allegations contained in the first sentence of paragraph 3 and alleges that a total of $12,878.15 was paid on November 16, 1965. The defendant denies all other allegations contained in paragraph 3, except admits that a timely claim for refund was filed on December 7, 1965.

WHEREFORE, the defendant prays that the complaint be dismissed with prejudice, and that the defendant be allowed its costs and disbursements.

/s/ KENT SANDIDGE, III
Assistant United States Attorney

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

MOTION FOR SUMMARY JUDGMENT

(Filed October 19, 1966)

Plaintiffs move the Court to enter, pursuant to Rule 56 of the Federal Rules of Civil Procedure, a summary judgment in plaintiffs' favor for the relief demanded in the complaint, on the ground that there is no genuine issue as to any material fact and that plaintiffs are entitled to a judgment as a matter of law.

This motion is based upon:

(a) The pleadings.

(b) The affidavit of Maclin P. Davis taken on October 5, 1966, which is filed herein.

(c) The affidavit of Lee Davis taken on October 18, 1966, which is filed herein.

(d) Plaintiffs' brief in support of motion for summary judgment which is attached hereto and made a part hereof.

WALLER, LANSDEN & DORTCH

By /s/ WILLIAM WALLER

/s/ ROBERT G. MCCULLOUGH
Attorneys for Plaintiffs
1200 American Trust Building
Nashville, Tennessee 37201

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT IN SUPPORT OF PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

(Filed October 19, 1966)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

MACLIN P. DAVIS, being duly sworn, deposes and says:

1. I am one of the plaintiffs in the above styled case and I am making this affidavit as to facts within my own knowledge in support of plaintiffs' motion for summary judgment.

2. I am President of Tennessee Foundry & Machine Company and have served as President since its incorporation on April 20, 1945, as successor to a going business theretofore operated as a partnership. A copy of the Certificate of Incorporation is annexed hereto as Exhibit A. Before this corporation was organized, I applied to the Reconstruction Finance Corporation and The American National Bank, of Nashville, Tennessee, for a loan of $95,000 to be made to the corporation when organized. In the course of negotiations and conversations regarding this loan, I was advised that the corporation would be required to deposit in a bank a minimum of $25,000 to be used as additional working capital, to be obtained either by the sale of preferred stock or by the issuance of a subordinated deferred note. In order to obtain the loan for the corporation, I agreed to provide the necessary working capital for the corporation. My agreement in this regard is set forth in a letter dated April 25, 1945, to The American National Bank, a copy of which is annexed hereto as Exhibit B. The approval of the loan by the Reconstruction Finance Corporation is shown

by its letter dated May 2, 1945, annexed hereto as Exhibit C, expressly providing that its approval is subject to certain enumerated terms and conditions, including the condition that the borrower have a minimum of $25,000 on deposit to be used for working capital. Annexed hereto as Exhibit D is a letter dated May 3, 1945, from The American National Bank to Smaller War Plants Corporation stating that no part of the loan would be disbursed until the required $25,000 had been deposited. As mentioned above, it was agreed that I could provide the necessary working capital either by loaning the money to the corporation and taking a subordinated deferred note or by purchasing preferred stock. I decided to purchase preferred stock because I was told that this would be preferable from the standpoint of the corporation's balance sheet. The charter, Exhibit A hereto, was drafted so as to authorize 1,000 shares of preferred stock, par value $25 per share, all of which I purchased on the dates and in the amounts shown by copies of my personal checks which are annexed hereto as Exhibit E. It was my intention at that time to hold the preferred stock only as long as was necessary to comply with the conditions of the loan from Reconstruction Finance Corporation and The American National Bank. Paragraph 7 of the Reconstruction Finance Corporation letter, Exhibit C hereto, provided that I agreed to not withdraw from the corporation any funds in excess of a specified salary, and it was my understanding that this agreement prohibited redemption of the stock. It was always understood and agreed between myself and the corporation that my preferred stock would be redeemed as soon as the loan was paid.

3. After the obtaining of the $95,000 loan in 1945, it became necessary to refinance and increase the loan to $110,000 in 1946. A copy of the letter of Reconstruction Finance Corporation dated July 16, 1946, agreeing to the increase in the amount of the loan is annexed hereto as Exhibit F. Due to financial difficulties of the corporation during these years, it was necessary to reduce the amount of the monthly payments and extend the loan.

The final payment on the loan was made on June 1, 1963. At a special meeting of the Board of Directors of the corporation called and held on September 23, 1963, the following resolution was adopted:

> WHEREAS, Maclin P. Davis, holder of 1,000 shares of the preferred stock of the corporation, which was originally issued to him for the consideration of $25,000, has offered to accept the sum of $25,000 for said preferred stock;
>
> BE IT RESOLVED, That the 1,000 shares of Preferred Stock held by Maclin P. Davis be redeemed by acceptance of his said offer and the payment to him by this corporation of $25,000 for said stock, which payment shall take place on October 1, 1963, upon the surrender of the certificates for said 1,000 shares of Preferred Stock; and
>
> BE IT FURTHER RESOLVED, That the Treasurer is directed and authorized to cause the same to be paid on the date specified.

In accordance with the resolution quoted above, I surrendered my certificate representing the 1,000 shares of preferred stock and received a check of the corporation for $25,000.

4. The examination report of the Internal Revenue Service, dated June 11, 1965, states that ". . . a redemption of stock which does not change the essential relationship between the shareholder and the corporation is considered to be equivalent to a dividend. The taxpayer, by virtue of the percentage of shares of common stock owned by him individually . . . and constructively . . . was solely in control of the corporation both before and after redemption of the preferred stock." The explanation then says that the distribution in redemption is accordingly considered to be the "equivalent of a dividend."

5. As is shown by the Charter of Tennessee Foundry & Machine Company, Exhibit A hereto, a total of 1,000 shares of no par common stock are authorized in addition to the 1,000 shares of preferred stock. At the time

the corporation was organized, I subscribed to 250 shares of the common stock, my wife subscribed to 250 shares, and E. B. Bradley subscribed to 500 shares. Ownership of the common stock remained the same until 1952 when I bought the 500 shares of common stock owned by Mr. Bradley. In 1959, I transferred 250 shares to my son and 250 shares to my daughter. There have been no further transfers of common stock.

6. In 1960 Tennessee Foundry & Machine Company sought and obtained the consent of Reconstruction Finance Corporation to the payments of dividends on the common and preferred stock. Beginning on October 5, 1960, regular semi-annual dividends were paid on both the common and preferred stock.

/s/ MACLIN P. DAVIS

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT OF LEE DAVIS

(Filed October 19, 1966)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

LEE DAVIS, being duly sworn, deposes and says:

1. I am a resident of Davidson County, Tennessee, and am a financial counselor with my office on the 23rd floor of the Life & Casualty Tower, Nashville, Tennessee. I have read the affidavit of Maclin P. Davis with regard to the above case, and I am familiar with certain of the transactions described in his affidavit. I am making this affidavit as to facts within my own knowledge.

2. I was employed by Reconstruction Finance Corporation at its office in Nashville, Tennessee, from the date it opened on March 10, 1932, until it closed on October 1, 1953. I served as Assistant Manager of the Nashville office from sometime in 1932 until 1950 and as Manager thereafter. In my capacity as Assistant Manager, I personally supervised the loan of Reconstruction Finance Corporation to Tennessee Foundry & Machine Company in 1945, in which The American National Bank participated to the extent of 10%. Tennessee Foundry & Machine Company was a new corporation but it was a successor to a business which had been operated as a partnership and was considered by RFC as a going concern. When the application for a loan was made, I determined, in accord with our standard policy and in concurrence with the Agency Manager and the Bank, to require the principals of the business to provide additional working capital in the amount of $25,000. It was a standard procedure of RFC to require, as a condition of a loan, that additional money be provided to the corporation, to be

retained in the corporation as long as the loan was outstanding or until the lender gave its consent to any modification. It was immaterial to RFC whether this money was put into the corporation as a purchase of preferred stock or common stock or as a subordinated loan. The requirements imposed upon Tennessee Foundry to obtain this loan were not unusual but in fact were standard requirements and conditions required of any borrower at the time the loan was made in order to provide sufficient operating capital. I have been shown a copy of a letter dated May 2, 1945, from RFC to The American National Bank concerning this loan over the signature of J. M. Gardenhire, Manager, whose signature I recognize. The condition expressed in paragraph 7 of that letter was included to prevent Tennessee Foundry from redeeming the preferred stock sold to Mr. Maclin Davis as long as the loan was outstanding.

3. I have noticed that certain of the correspondence, copies of which are annexed to the affidavit of Mr. Maclin P. Davis, are addressed to Smaller War Plants Corporation. This was a corporation organized by the United States Government to make particular types of loans in connection with the war effort. This corporation was subsequently merged into Reconstruction Finance Corporation and at all times was operated by RFC with RFC personnel. In other words, for all practical purposes, there is no distinction between Smaller War Plants Corporation and RFC.

/s/ LEE DAVIS

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

DISCOVERY DEPOSITION OF
MR. MACLIN P. DAVIS

(Filed December 16, 1966)

[fol. 1] The deposition of MR. MACLIN P. DAVIS, taken on discovery on behalf of the defendant, at the offices of Waller, Lansden & Dortch, 1301 American Trust Building, Nashville, Tennessee, pursuant to agreement of counsel as to time and place of taking, commencing at eleven o'clock, a.m., on December 1, 1966, before Mrs. Helen S. Draper, a notary and Court reporter for Davidson County and the State of Tennessee.

All formalities as to notice, caption and certificate are waived, and it was stipulated by and between counsel that the signature of the witness to his deposition is waived.

APPEARANCES:

For the Plaintiffs:

HON. WILLIAM WALLER, and
HON. ROBT. G. MCCULLOUGH,
Of Waller, Lansden & Dortch
American Trust Building
Nashville, Tennessee

For the Defendant:

HON. STENNIS LITTLE, JR.,
Tax Division
Department of Justice
Washington, D.C.

[fol. 2] MR. MACLIN P. DAVIS

having been first duly sworn, was examined and deposed as follows:

BY MR. LITTLE:

Q Would you please state your name and address, sir, for the record?

A Maclin P. Davis, Nashville, Tennessee.

Q Now, just generally when was the Tennessee Foundry and Machine Company started?

A In 1945.

Q Now, do you recall the original capital contribution that was made to the corporation, in addition to the $25,000 that you contributed for the preferred stock?

A Well, it was in assets valued at approximately twenty thousand dollars.

Q What sort of assets were they?

A Well, it was machinery that I had owned through the liquidation of the Seling Aircraft Corporation.

Q Now, what about Mr. Bradley, did he make a capital contribution?

A He purchased the property, he and a fellow, I believe his name was Gilliam, and operated as a partnership prior to my getting into it, and I came into it after Mr. Gilliam left.

Q So he owned part of the assets that were transferred to the corporation?

[fol. 3] A That's right.

Q I see. Now, was there any other cash contributed to the corporation that you can recall?

A Not by me.

Q What about Mr. Bradley?

A Yes, he paid cash for the property, he and Mr. Gilliam, the property where the Tennessee Foundry & Machine Company is now located, part of that property.

Q But wasn't that before you contributed the assets for the corporation?

A Yes, sir.

Q But now, I'm talking about when you made the capital contribution to the corporation in addition to those assets we are talking about. Was there any other cash contributed other than the $25,000?

A I don't know what the deals between Mr. Bradley and Mr. Gilliam were, and how much cash they put in,

other than that they owned this property, this building and the real estate there.

Q Was Mr. Gilliam a shareholder in this corporation?

A No, sir.

Q He was out of it, then, when you transferred it? Is that right?

A When we transferred it. That's right.

Q So you just don't recall whether or not the Com- [fol. 4] pany had any cash at the time they started in 1945, in addition to the equipment?

A Yes, they had, because they had been operating.

Q So in addition to the equipment, you transferred all the assets of the partnership, is that the way it was?

A I don't quite follow you.

Q Well, in addition to the machinery we're talking about, did you transfer other assets? The partnership had other assets other than the machinery?

A Oh, yes, they had some accounts receivable and a small inventory. It wasnt' a big company. It was a small organization.

Q Yes, sir, that's what I was getting at. Now, you have submitted an affidavit giving us some details on exactly the transaction involved with the Reconstruction Finance Corporation and the American National Bank of Nashville, but now for purposes of this deposition, if you would, just give us in your own words some information pertaining to that loan, just more or less give it to us in your own words right now, if you don't mind.

A Do you mean the reason for applying for the loan and so on?

Q Yes, sir.

A Well, the loan was to build the foundry building that we have there now, and to get a large foundry [fol. 5] operation in there, and that was the purpose, why I was interested in going in with Mr. Bradley, you see, the expansion of the business from the partnership that he had.

Q Now, who was it exactly that required the additional $25,000 contribution?

A The RFC.

Q So now the corporation went along and in 1963 they ultimately paid off this loan. Is that correct?

A That's correct.

Q And then subsequent to that, the corporation, that is the Tennessee Foundry & Machine Company, paid you $25,000 for all of your preferred stock?

A Yes.

Q Now, at the time that the corporation, the Tennessee Foundry & Machine Company, paid you the $25,000, Mr. Davis, how much stock did you own in the corporation?

A I personally owned 250 shares of the common stock.

Q And who else at that time—

A My wife owned 250 shares of the common stock. My daughter owned 250 shares, and my son owned 250 shares.

Q Now, that was immediately prior to the—

A Well, they owned that possibly several years before.

Q Prior to your receiving the $25,000?

A Yes, sir, several years.

Q And after?

[fol. 6] A Oh, yes, they still own the same amount.

Q Now, at the time that the corporation decided to give you the $25,000 for all of the preferred stock of the corporation, what caused the corporation to give you this at that time?

A Well, they were in a position to pay it off without having to borrow any money. We haven't borrowed any money from anybody since that has been paid off. It was surplus money and, as I stated before, it was my understanding that when the RFC would be liquidated and the bank loans were liquidated, it would be redeemed.

Q Well now, was there any business reason at that time to give you $25,000 for all of your preferred? And when I say "business reason", I am referring to corporate business reason.

A Well, it had this cash in the bank and the corporation was paying 6% on it, and it relieved the corporation of paying that, that's the only thing. I mean the corporation had the cash, the money to pay it off according to understanding, according to agreement, and we

did not have to do any financing whatsoever in order to pay it off. And since that date, since 1963, the Company has still operated without having to replace that. I mean that we took $25,000 out of the cash account of the Company and we're still operating and we haven't borrowed any money to supplement it.

[fol. 7] Q Well now, other than just the corporation had the cash and was able to pay you $25,000 for the preferred stock, can you think of any compelling business reason that the corporation would have to give you $25,000 for it at that time? I'm talking about 1963.

A "Compelling reason", I don't understand.

Q Well, business reason or—

A Business reason was that when I put the $25,000 in in 1946, it was understood that when the RFC loan was paid off that the corporation would redeem that preferred stock, and those things had been done and the Company was in financial position to retire it without jeopardizing the financial position of the Company, and that is why it was carried out. The agreement was carried out that had been made twenty years prior to it.

Q Do you recall any particular reason when the corporation was formed and this additional $25,000 was required by the lender that you did not just get a note back from the corporation say, first?

A Well, that was discussed. I mean in order to get the loan of $95,000 from the RFC they wanted $25,000 worth of additional, I think the word they used, "equity" in the Company, and that I could take it either in preferred stock or a subordinated note, anything that that $25,000 would have to be subordinated to this $95,000 loan.

[fol. 8] Q Well, that was a requirement of the RFC in order to get the $95,000 loan, see, and the decision to take it out in preferred stock rather than a note was done because in the financial statement it would have shown up as an equity rather than as a liability, a note liability, and so that was the reason for the preferred stock. We decided, "Well, all right, take it out in preferred stock rather in a subordinated note."

Q What about the common?

A Well, the common was there.

Q Did you think about taking additional common, giving you a higher percentage of the ownership?

A No, the whole thing was that here was an agreement to retire this $25,000.

Q You were thinking about ultimately getting this back?

A I don't follow you, "ultimately". What do you mean?

Q Well, could you have not received this back if you had had common stock in the same manner that you did—

A I didn't put in the common stock, I already had the common stock. The agreement was based on this $25,000, how the $25,000 would be put in, and it was to be put in—I mean with the RFC and the American Bank—either by a subordinated note or preferred stock.

Q But they wouldn't have cared whether it was preferred or common?

A No common. They said how it would be put in, [fol. 9] all the discussion was based on this $25,000 would be either in preferred stock for $25,000, or a subordinated note for $25,000. Nothing was discussed about common stock at that date at all.

MR. WALLER: Off the record a minute.

(Short discussion off the record.)

Q Of course, my question was directed, was there any reason why he didn't want to have a higher percentage of the common stock, he could have made a capital contribution and received a higher percentage than his fifty per cent that he had at that time with Mr. Bradley. That is the way the question was really intended. Do you see what I mean?

A Yes. Now, I follow you. The reason from that angle Bradley wanted to maintain in the equity of the Company a fifty-fifty basis with me, see.

Q Well now, is this a fair statement, Mr. Davis: That you consider that the business reason for the redemption in 1963 was really—resulted really from the business reason that required you to put up $25,000 in 1945?

A I don't quite follow that.

Q Well, let me try to rephrase it. In other words, as I understand, Mr. Davis, you're saying there was a business reason now for you to redeem your stock from the corporation in 1963. Is that fair?

A Well, what do you mean by "business reason" [fol. 10] there?

Q Just a corporate business reason. In other words, if you were just a corporate executive and weren't a shareholder, looking at it from the corporate viewpoint?

A Well, my whole thinking on the whole thing was based on the fact that I put this in, was required to put it in in order to get a loan of $95,000?

Q Now, this was in 1945?

A '45, with the understanding that I could withdraw this amount, that it would be redeemed, paid off by the corporation after the loan was paid.

Q So the business reason was really in 1945, and that reason was simply that you had to have an additional $25,000—

A In order to get the loan.

Q —to get the loan?

A In order to get the loan. We would not have gotten the loan had we not done it, and when that part of the whole transaction was completed—

MR. LITTLE: Well, I don't think I have any other questions.

MR. WALLER: Nothing further, Mr. Davis. Thank you, sir.

And further this deponent sayeth not.

(Signature waived)

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

CROSS-MOTION FOR SUMMARY JUDGMENT

(Filed May 10, 1967)

The defendant, through its attorney, Gilbert S. Merritt, Esquire, United States Attorney, for the Middle District of Tennessee moves the Court, pursuant to Rule 56 of the Federal Rules of Civil Procedure for summary judgment in the defendant's favor on the grounds that there is no genuine issue as to any material fact, and that the defendant is entitled to a judgment as a matter of law. This motion is based upon:

(a) Pleadings.

(b) Affidavit of Maclin P. Davis taken on October 5, 1966, and attached to the plaintiffs' motion for summary judgment (with the exception noted in the affidavit of H. Stennis Little, Jr., which is attached hereto).

(c) The affidavit of Lee Davis taken on October 18, 1966, which is attached to the plaintiffs' motion for summary judgment.

(d) The affidavit of H. Stennis Little, Jr., which is attached hereto and made a part hereof.

(e) The defendant's brief which is attached hereto and made a part hereof.

/s/ KENT SANDIDGE, III
Assistant United States Attorney

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT

(Filed May 10, 1967)

CITY OF WASHINGTON)
) ss:
DISTRICT OF COLUMBIA)

Before me came and appeared H. Stennis Little, Jr., who, being duly sworn, stated:

Affiant is an attorney employed by the United States Department of Justice and has been assigned the responsibility for the handling of this captioned case; he has in his possession the files maintained by the Commissioner of Internal Revenue with respect to the income tax return filed on behalf of plaintiffs, together with files maintained by the Department of Justice with respect to this captioned case.

1. This affidavit is filed in accordance with Rule 56(e) of the Federal Rules of Civil Procedure and takes exception to one statement made in the affidavit of Maclin P. Davis. The statement made on page 2 of the affidavit maintains that $25,000 was to be acquired as additional working capital and that such amount was to be obtained either by the sale of preferred stock or by the issuance of a subordinated deferred note. This statement was believed to have been made inadvertently by Mr. Davis and affiant no longer believes that Mr. Davis maintains that preferred stock or a subordinated deferred note were the only means whereby the $25,000 in working capital could be obtained. The affidavit of Lee Davis and the deposition of Mr. Maclin P. Davis, taken pursuant to the Federal Rules of Civil Procedure, indicate that the $25,000 of working capital could have also been obtained by the issuance of common stock. This is the position that was taken on the brief which was submitted by the

taxpayers to support their motion for summary judgment.

2. The names of Mr. and Mrs. Davis's children are: Maclin P. Davis, Jr. and Edith Davis Whitman (the names have not been previously presented into the record).

3. True copies of the Tennessee Foundry & Machine Co., Inc.'s tax returns for the fiscal years ended March 31, 1961, 1962, 1963, 1964 and 1965 are attached to this affidavit as exhibits 1, 2, 3, 4, and 5, respectively.

4. True copies of original and amended income tax returns for the year 1963 are attached to this affidavit as exhibits 6 and 7 respectively.

/s/ H. STENNIS LITTLE, JR.
H. STENNIS LITTLE, JR.
Attorney
Department of Justice
Washington, D.C. 20530

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT

(Filed July 24, 1967)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

Maclin P. Davis, Jr., being first duly sworn, deposes and says:

1. I am a director, stockholder and secretary of Tennessee Foundry & Machine Company. I have been a director of that corporation since 1950. I was Vice President of the corporation from 1950 until 1964 and have been Secretary of the corporation since 1962.

2. The outstanding stock of said corporation consists of 1,000 shares of common stock. My father, Mr. Maclin P. Davis, my mother, Mrs. Edith U. Davis, my sister, Mrs. Harold B. Whiteman, and I own 250 shares each of the common stock and are the only stockholders of this corporation. My parents have another daughter, Mrs. Penn Owen, Jr., who does not own any stock in the corporation. My mother and father each have owned 250 shares of the common stock since 1945 when the corporation was formed. My sister, Mrs. Whiteman, and I have each owned 250 shares since 1959. This stock was purchased by my father from Mr. E. R. Bradley and later given to us.

3. I am 41 years of age and married and have three children, ages 13 years, 10 years, and 8 months. My wife and children and I live in Davidson County, Tennessee, in our own home. I have not resided in my father's home since 1953. I have been engaged in the practice of law in Nashville, Tennessee, since 1950 and have not been dependent upon my father since prior to that time.

4. My sister, Mrs. Whiteman, is 42 years of age and resides in New York, New York, with her husband and three children, whose ages are approximately 18 years, 16 years, and 14 years. Mrs. Whiteman has been married since 1946 and has not lived at my father's home nor been dependent upon him since that time. Mrs. Whiteman has never been a director or officer of the corporation.

5. I have read the affidavit of my father, Mr. Maclin P. Davis, dated October 5, 1966, and filed in support of plaintiffs' motion for summary judgment in this case and have also read his discovery deposition. All the facts stated in my father's affidavit and testified to in his deposition are in accordance with either my actual knowledge or with information which I had received prior to the time, in 1965, a revenue agent adjusted the 1963 income tax liability of my father and mother by treating the redemption price of the corporation's preferred stock as a dividend.

6. It has been my understanding since 1950 that my father's preferred stock could not be retired until the company's RFC loan was paid off. When my father's preferred stock was redeemed on October 1, 1963, the RFC loan had been paid off and the corporation was in a financial position to redeem the stock. 1963 was the first time these conditions had been met. It was considered by the company's directors and its auditor, Mr. John Glenn, Jr., that it was to the company's advantage to redeem the stock at that time because this $25,000 of additional capital was no longer needed and the redemption of the preferred stock eliminated the 6% cumulative dividend of $1,500 per annum. The common stock dividends paid by the company for the fiscal years ending on March 31 from 1961 through 1967 were as follows:

Year	Common Stock Dividends
1961	1,000
1962	2,000
1963	2,000
1964	2,000
1965	6,500
1966	8,000
1967	8,000

This affidavit is made by me in support of plaintiffs' motion for summary judgment and in opposition to defendant's cross-motion for summary judgment.

/s/ MACLIN P. DAVIS, JR.

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT

(Filed July 24, 1967)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

William Waller, being first duly sworn, deposes and says:

The affidavit of H. Stennis Little, Jr. in this case makes the following statement: "The affidavit of Lee Davis and the deposition of Mr. Maclin P. Davis, taken pursuant to the Federal Rules of Civil Procedure, indicate that the $25,000 of working capital could have also been obtained by the issuance of common stock." It is true that so far as the RFC was concerned, it was immaterial whether preferred stock or common stock was issued. However, Mr. Bradley, who received 50% of the common stock in exchange for property, was unable or unwilling to put up cash for additional capital, but at the same time insisted on retaining 50% of the voting power. For this reason, no consideration was ever given to providing the additional $25,000 of capital except by subordinated debentures or preferred stock.

This affidavit is made by the undersigned rather than by Mr. Davis because he is in Europe and is unavailable. The undersigned acted as legal counsel in the organization of the corporation and was familiar with the facts stated.

/s/ WILLIAM WALLER

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

MEMORANDUM

(Filed September 15, 1967)

This civil action was instituted by Maclin P. Davis[1] (hereinafter the taxpayer) against the United States of America (hereinafter the government) for a refund of income taxes and interest paid in response to an assessment by the Internal Revenue Service. The controversy arises out of a redemption at par of certain shares of preferred stock owned by taxpayer which the Internal Revenue Service treated as a dividend distribution to which § 301 of the Internal Revenue Code applies. Taxpayer maintains that this distribution constituted a redemption "not essentially equivalent to a dividend" within the meaning of § 302(b)(1) and thus qualifies as a distribution "in exchange for the stock" under § 302(a). The cause is now before the Court on the motions of both parties for summary judgment.

I

In April, 1945, taxpayer and E. B. Bradley organized the Tennessee Foundry and Machine Company (hereinafter the corporation) for the purpose of manufacturing steel castings. Prior to incorporation, taxpayer had entered into negotiations with the Reconstruction Finance Corporation (hereinafter the RFC) and the First American National Bank of Nashville, Tennessee, for the purpose of obtaining a $95,000 loan to the corporation. The prospective lenders agreed to make the loan if certain terms and conditions were met. The main prerequisite was that the incorporators provide the corporation with an additional $25,000 working capital either by making

[1] Edith U. Davis, taxpayer's wife, is a party to the suit because a joint return was filed.

a loan evidenced by a subordinated deferred note or by purchasing preferred or additional common stock.

Bradley, who had received 50 percent of the common stock in exchange for property transferred to the corporation, was unable or unwilling to invest additional capital but insisted on retaining 50 percent of the voting power. Consequently, the only methods of raising this additional capital considered by taxpayer were purchasing preferred stock or taking subordinated debentures in exchange for a loan. Taxpayer decided the former was preferable, giving as his reason that this would be more desirable than an outright loan from a balance sheet standpoint. Taxpayer contends that the sole purpose of this transaction was to enable the corporation to obtain the RFC loan, and that all concerned were in agreement that this stock would be held only until the loan was repaid at which time it would be redeemed.

Upon approval of the loan application by the RFC, taxpayer purchased 1,000 shares of 6 percent preferred stock at par value of $25 per share as authorized by the charter of the corporation. Thus, as of the date of incorporation or shortly thereafter, the outstanding shares were held as follows:

Shareholder	Common - %	Preferred - %
E. B. Bradley	500 - 50	
Maclin P. Davis	250 - 25	1,000 - 100
Edith U. Davis	250 - 25	

Due to financial difficulties encountered by the corporation, the loan was refinanced in 1946. The principal was increased to $110,000 and the maturity date was extended.

In 1952, taxpayer purchased the 500 shares of common stock owned by Bradley and in 1959 he transferred 250 of these shares to his son, M. P. Davis, Jr., and 250 shares to his daughter, Edith D. Whiteman. Consequently, at the time of the redemption in question the ownership of the outstanding shares of the corporation was as follows:

Shareholder	Common - %	Preferred - %
Maclin P. Davis	250 - 25	1,000 - 100
Edith U. Davis	250 - 25	
M. P. Davis, Jr.	250 - 25	
Edith D. Whiteman	250 - 25	

The original loan agreement provided that, as long as any part of the loan was outstanding, no dividends could be paid without first obtaining the prior written consent of the Bank and the RFC. In 1960, permission was granted to declare dividends on the outstanding stock. Consequently, semi-annual dividends in the amount of $750 were paid on the preferred stock beginning on October 5, 1960.

On September 23, 1963, after final payment on the loan had been made,[2] the board of directors of the corporation resolved to redeem the preferred stock by accepting taxpayer's offer to transfer these shares in exchange for the sum of $25,000. On October 1, 1963, taxpayer surrendered the certificate representing the stock and was paid $25,000.

Taxpayer, characterizing the distribution as a return of capital, did not report this amount as income in his 1963 return on the theory that no gain had been realized because his basis in the preferred stock was equal to the amount received. After an audit, the Internal Revenue Service concluded that the amount received pursuant to the redemption constituted a distribution of property within the meaning of § 301 and thus was essentially equivalent to a dividend and taxable as ordinary income. Upon the Commissioner's denial of a claim for a refund, this action was commenced.

II

The general rule of § 301 is that a distribution by a corporation to a shareholder with respect to his stock is treated as a dividend to the extent of the corporation's earnings and is includable in the recipient's gross in-

[2] Final payment was made June 1, 1963.

come, unless the distribution can be brought within an exception to this rule. The relevant exception here is found in the provisions of § 302 dealing with distributions in redemption of stock.

Under § 302(a), corporate redemptions are to be treated as distributions in part of full payment for the stock redeemed if the transaction comes within one of the four subdivisions of § 302(b). Section 302(b)(1) provides that a redemption which "is not essentially equivalent to a dividend" falls within the protective scope of § 302(a). Thus, if a redemption qualifies under § 302(b)(1), the distribution is treated as a payment in exchange for stock under § 302(a) with the result that it is not includable in gross income as a dividend and any amount realized on the redemption is entitled to capital gains treatment.

The determinative issue, therefore, is whether the amount received by taxpayer pursuant to the redemption in question is "essentially equivalent to a dividend" and thus taxable as ordinary income.

III

However, before the basic issue of dividend equivalency can be decided, the preliminary question of the bearing of the § 318(a) family attribution rules upon § 302(b)(1) must be resolved.

The government contends that the attribution rules are automatically applicable on the ground that § 302(c)(1) specifically provides that § 318(a) "shall apply in determining the ownership of stock for the purposes of this section." If the attribution rules are applicable, taxpayer must be regarded as the constructive owner of all of the outstanding stock of the corporation and the redemption must be characterized as basically pro rata.

Taxpayer, in assuming a contrary position, reasons that the language of § 318(a), which provides that it is applicable only to "those provisions of this subchapter to which the [attribution] rules . . . are expressly made applicable," precludes applicability to § 302(b)(1) because § 318(a) is relevant to § 302(b) only for the purpose of determining stock ownership and § 302(b)(1),

unlike the other subdivisions of § 302(b), does not expressly refer to stock ownership, but rather speaks in terms of the effect of the redemption. Thus, it is argued that the "non-fact" of constructive ownership is not properly a part of the factual inquiry into the effect of the distribution required by § 302(b)(1).

Taxpayer further asserts that the legislative history of § 302(b)(1) also precludes automatic applicability of the attribution rules. In support of this contention, taxpayer argues that § 302(b)(1) was intended to incorporate existing law as to whether a redemption is essentially equivalent to a dividend[3] and that under § 115(g) of the 1939 Code the ownership of the remaining stock was only one element in a primarily factual determination.

Although taxpayer's contentions are not without some persuasiveness,[4] the Court is of the opinion that the weight of authority supports the government's position that the attribution rules apply under § 302(b)(1). See, e.g., *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (10th Cir. 1966); *Levin* v. *Commissioner*, 47 T.C. 258 (1966); Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 292 (2d Ed. 1966). For the purpose of determining dividend equivalency, therefore, ownership of all of the outstanding common stock of the corporation is attributable to the taxpayer with the effect that the distribution was essentially pro rata. Consequently, corporate ownership cannot be regarded as affected in any substantial way by the transaction.

However, dividend equivalency does not necessarily follow from the Court's conclusion that the attribution rules are applicable under § 302(b)(1).

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[3] Sen. Rep. No. 1622, 83d Cong. 2d Sess. 44 (1954): "In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry."

[4] Cf. Lewis v. Commissioner, 47 T.C. 129 (1966).

IV

While the words "not essentially equivalent to a dividend" are not further defined by Congress, it is clear that the intent of Congress in enacting § 302(b)(1) was that the "test for determining whether a redemption was 'essentially equivalent to a dividend' should be the same as the test utilized in interpreting and applying the same words in § 115(g)(1) of the 1939 Code." *Kerr* v. *Commissioner*, 326 F. 2d 225, 230 (9th Cir. 1964). Some attention, therefore, must be given to the tests developed under the 1939 Code in order to ascertain present standards of administering § 302(b)(1).

Prior to *Flanagan* v. *Helvering*, 116 F. 2d 937 (D.C. Cir. 1940), it was generally held that the applicability of § 115(g) to a stock redemption was a factual question in which the basic criterion was whether the transaction was motivated by a legitimate corporate business purpose as distinguished from mere tax avoidance.[5] However, in *Flanagan*, at 939-940, the Court took the position that "the net effect of the distribution, rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering § 115(g)." Under this objective test, business purpose as the basic criterion for the applicability of § 115(g) was replaced by an analysis of the net effect of the redemption transaction. However, many of the courts which purported to follow the net effect test, in effect, expanded that test to include inquiry into the possibility of an underlying legitimate business motive. See, e.g., *Boyle* v. *Commissioner*, 187 F. 2d 557 (3rd Cir. 1951), cert. denied 342 U.S. 817; *Commissioner* v. *Snite*, 177 F. 2d 819 (7th Cir. 1949); *Hirsh* v. *Commissioner*, 124 F. 2d 24 (9th Cir. 1941).

In *Keefe* v. *Cote*, 213 F. 2d 651 (1st Cir. 1954), the Court had the alternative of following the net effect test as set forth in *Flanagan*, *supra*, or as broadened by subsequent cases which inquired into the motive under-

[5] This test is generally met when a corporation has effected a preconceived legal plan to improve the corporation's standing as opposed to a plan which primarily benefits the stockholders.

lying the transaction. The taxpayer, who owned in excess of 90 percent of the stock of a closely held corporation, had been issued the redeemed stock in exchange for a note previously given him in settlement of salaries due. When the stock was subsequently redeemed at an amount representing its appreciated value, the taxpayer argued that the increment was entitled to capital gains treatment. The Court upheld this contention, holding that the redemption was a step in carrying out a legitimate corporate purpose.[6]

In the opinion of the Court, *Keefe* v. *Cote*, *supra*, is to be read as reviving the "proposition that if there is a legitimate corporate purpose for the acquisition of stock by the issuing corporation, it [the redemption] is not essentially equivalent to the distribution of a taxable dividend." *United States* v. *Fewell*, 255 F. 2d 496, 500 (5th Cir. 1958).

Thus, while the net effect of the distribution is generally regarded as the most important consideration in determining dividend equivalency, there are two positions within this rule which, for purposes of convenience, may be described as the "strict" and the "flexible" net effect tests. Under the former, the ultimate result of the distribution is evaluated without regard to any underlying business purpose, while, under the latter, motivation may be properly considered in ascertaining the ultimate effect.

Upon consideration, the Court is of the opinion that the "flexible" net effect test is the preferable method of ascertaining § 302(b)(1) dividend equivalency. Consid-

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[6] Although taxpayer owned 93.9 percent of the stock and the distribution was therefore essentially pro rata, the Court did not regard the fact that the objective result of the transaction was essentially equivalent to a dividend as determinative. Rather, the Court focused on the taxpayer's testimony that the stock had been issued to him for the purpose of improving the corporate credit standing and with the understanding that the stock would be redeemed whenever it was convenient for the corporation to do so. The Court concluded that dividend equivalency was lacking on the grounds that the redemption was a part of the original transaction and that the improvement of the corporation's credit standing was a legitimate corporate business purpose.

ering the possibility of a justifying business purpose as a factor in this determination more clearly recognizes that the outcome will generally depend "upon the facts and circumstances of each case." Federal Income Tax Regulations, § 1.302-2(b). The question before the Court, therefore, is whether there is a legitimate business purpose underlying this distribution which is sufficiently compelling to overcome the objective fact that its pro rata nature "points to a tax avoidance scheme." *Ballenger* v. *United States*, 301 F. 2d 192, 199-200 (4th Cir. 1962).

While recognizing that there was a legitimate business purpose underlying the issuance of the preferred stock in 1945, the government maintains that there was no comparable justification for the redemption in 1963. This assertion is not well taken. In determining whether the instant case satisfies the "flexible" net effect test, it is not essential that the issuance and the redemption must have been motivated by distinct business purposes. Rather, it is sufficient if it can be found that "there was a corporate business purpose in issuing the shares and . . . that they were redeemed in carrying out that purpose." *Keefe* v. *Cote*, *supra*, at 657.

It is clear that the preferred stock was issued solely in order to provide the additional security required by the RFC as a precondition to making the initial $95,000 loan. Based on the facts as set forth in the record, the Court is of the opinion that it was understood that the corporation would subsequently redeem these shares when the RFC loan was repaid and that the redemption in 1963 was the final step in carrying out the original purpose of obtaining this loan. Of course, at the time the preferred stock was issued and its redemption planned, such redemption would not have been pro rata. The subsequent acquisition of Bradley's stock holdings by taxpayer, making the redemption distribution essentially pro rata because of the § 318(a) attribution rules, neither impairs the legitimacy of the purpose underlying the issuance of the preferred stock nor alters the fact that the redemption was simply the final step taken in completion of this purpose.

Accordingly, the Court holds that the amount received by taxpayer in exchange for his 1,000 shares of preferred stock was not essentially equivalent to a dividend within the meaning of § 302(b)(1) of the Code and must, therefore, be treated as a distribution in part or full payment for the stock redeemed, under § 302(a).

An appropriate order will be submitted within twenty (20) days.

/s/ FRANK GRAY, JR.
United States District Judge

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

ORDER

(Filed October 5, 1967)

This action came on for hearing before the Honorable Frank Gray, Jr. upon motions for summary judgment supported by affidavits filed by both parties and, upon consideration thereof, the Court having rendered and filed its Memorandum on September 15, 1967,

It is ORDERED and ADJUDGED that the plaintiffs recover of the defendant the sum of $12,910.51 together with interest thereon at the rate of six percent per annum from and after November 15, 1965, and their costs of this action.

/s/ FRANK GRAY, JR.
Judge

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

MOTION FOR REHEARING

(Filed October 9, 1967)

The defendant, the United States of America, by its attorney, Gilbert S. Merritt, Esquire, United States Attorney for the Middle District of Tennessee, moves the Court for a rehearing in the above-entitled case for the reason that the Court's decision of September 15, 1967, is contrary to the cases of *Ballenger* v. *United States*, 301 F. 2d 192 (C.A. 4th) and *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (C.A. 10th). Furthermore, it is respectfully submitted that the Court's decision allows for tax avoidance planning in setting up newly formed corporations. An oral hearing on this matter is requested.

GILBERT S. MERRITT
United States Attorney

By: /s/ KENT SANDIDGE, III
Assistant United States Attorney

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

ORDER

(Filed October 19, 1967)

This case was called October 19, 1967, for hearing on the motion for rehearing heretofore filed by the defendant. After hearing argument of counsel for the defendant in this regard, the Court was of the opinion that the motion was not well taken.

Accordingly, it is ORDERED that the motion for rehearing heretofore filed by the defendant be, and the same is hereby, denied.

/s/ FRANK GRAY, JR.
United States District Judge

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 18487

MACLIN P. DAVIS AND EDITH U. DAVIS,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

On Appeal from the United States District Court for the Middle District of Tennessee

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Decided March 27, 1969

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges* and MCALLISTER, *Senior Circuit Judge.*

CELEBREZZE, Circuit Judge. The Government appeals a judgment of the United States District Court for the Middle District of Tennessee granting Taxpayer's [1] claim for refund of federal income taxes. The cause was heard on motions for summary judgment filed by both parties. On denial of its motion for rehearing the Government perfected this appeal. The question before us is whether a corporate distribution to Taxpayer, in redemption of all his preferred stock in the Corporation, was essentially equivalent to a dividend under Section 302(b)(1) of the Internal Revenue Code of 1954.[2]

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[1] Appellees filed a joint return. The designation "Taxpayer" throughout this opinion, however, shall refer to Maclin P. Davis.

[2] "Sec. 302. Distributions in Redemptions of Stock.

"(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated

In 1945, Taxpayer and one Bradley organized the Tennessee Foundry & Machinery Company (hereinafter Corporation) to manufacture steel castings. In exchange for equipment transferred to the Corporation, Bradley and Taxpayer each received fifty percent of its common stock. Prior to incorporation, Taxpayer had begun negotiations with the Reconstruction Finance Corporation (hereinafter RFC) for the purpose of obtaining a $95,000 loan to the Corporation. RFC agreed to make the loan on the condition that the incorporators provide the Corporation with additional working capital in the amount of $25,000. Bradley insisted on retaining his fifty percent of the voting power but was unwilling to invest any additional capital. In order to meet the demand of RFC, Taxpayer contributed the $25,000 in exchange for one hundred shares of six percent non-voting preferred stock with a par value of $25 per share. Taxpayer contended and the District Court found that the sole purpose of the transaction was to enable the Corporation to obtain the RFC loan and that the preferred stock was to be redeemed when the loan was repaid. Thus, on the date of incorporation the capital structure of the Corporation was as follows:

	Common—%	Preferred—%
Bradley	500 - 50	
Taxpayer	250 - 25	1,000—100%
Taxpayer's Wife	250 - 25	

In 1952, Taxpayer purchased Bradley's common stock and in 1959 he transferred 250 shares to his son and 250 shares to his daughter. The original loan agreement provided that so long as part of the RFC loan was out-

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as a distribution in part or full payment in exchange for the stock.

"(b) Redemptions Treated as Exchanges.—

"(1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend."

standing, no dividends could be paid without obtaining the written consent of RFC. Such permission was granted in 1960 and semiannual dividends were paid beginning on October 5th of that year.

On June 1, 1963 the loan was paid off and on September 23, 1963 the Corporation voted to redeem Taxpayer's preferred stock. On October 1, 1963 this stock was redeemed for $25,000, the amount Taxpayer paid for it. On this date the capital structure of the Corporation, reflecting the prior purchase of Bradley's shares by Taxpayer, was as follows:

	Common—%	Preferred—%
Taxpayer	250 - 25	1,000
Wife	250 - 25	
Son	250 - 25	
Daughter	250 - 25	

The Commissioner contended that the $25,000 was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Code, hence taxable as ordinary income under Section 301 of the Code.[3] The District Court held to the contrary and granted Taxpayer's claim for refund. We affirm the judgment of the District Court.

Section 302 of the Code provides capital gains treatment to corporate distributions made in redemption of stock. The transaction is treated as a sale or exchange of a capital asset and gain is realized to the extent that the distribution exceeds a taxpayer's cost basis for the stock. Here, Taxpayer received back his cost basis for the stock so he had no gain. On the other hand, corporate distributions amounting to dividends are includable in their entirety in gross income and taxed at ordinary rates. Where the question is whether a particular cor-

[3] Section 301(c) of the Code provides that gross income includes dividends. Section 316 of the Code defines a "dividend" generally as a distribution of property made by a corporation to its shareholders out of earnings and profits.

porate distribution is a redemption or dividend Section 302 provides several tests for determining the answer.[4] Since the Corporation was not liquidating its business and the stock redeemed was preferred stock with no voting rights, our inquiry is limited to Section 302(b)(1) which simply states the principle that a corporate distribution in exchange for stock is not a redemption if it is essentially equivalent to a dividend.[5]

We therefore look to the facts as found by the District Court to determine whether the distribution in issue was equivalent to a dividend. See *Ballenger* v. *United States*, 301 F. 2d 192 (4th Cir. 1962). The standard contained in Section 302(b)(1) calls for a factual resolution of the question and has been so used by the courts and the Commissioner. *Rheinstrom* v. *Commissioner*, 125 F. 2d 790 (6th Cir. 1942), cert. denied 317 U.S. 654; *Cobb* v. *Calan Court Co.*, 274 F. 2d 532 (5th Cir. 1960); *Colvin* v. *United States*, 175 F. Supp. 877 (S.D. Cal. 1959); Treasury Regulation 1.302-2(b). Our function on review is to determine whether the District Court applied the correct criteria to those facts. *Ballenger*, supra; but see *Pacific Vegetable Oil Co.* v. *Commissioner*, 251 F. 2d 682 (9th Cir. 1957) (dividend equivalency is mixed question of fact and law).

The purpose of the various tests in Section 302(b) of the Code is to prevent tax avoidance, more specifically, to prevent corporations from bailing out earnings to

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[4] Similar rules are contained throughout Code Sections 301-318 (distributions by corporations other than liquidating distributions) and Code Sections 331-346 (liquidating distributions.)

[5] By contrast, Subsections (2), (3), and (4) of Section 302(b) contain objective tests for determining whether the distribution was a redemption. Subsection (2) provides that substantially disproportionate distributions with respect to the shareholder are to be treated as redemptions under Section 302(a). By a limitation contained in that subsection, however, the shareholder must after the distribution end up with less than 50% of the total combined voting power in the corporation. Subsection (3) provides that a shareholder's stock is considered to be redeemed under Section 302(a) when he terminates his interest in the corporation. Subsection (4) deals with railroad corporations. This leaves for our consideration Subsection (1) of Section 302(b).

shareholders at favorable capital gains rates. To bring some objectivity to Section 302(b)(1), the Courts have established some guidelines which when applied to the facts of each case are calculated to determine whether a particular corporate distribution is in fact a dividend. Under the "strict net effect" test, if the taxpayer ends up in the same position after the distribution as he would have occupied had a dividend been declared, the net effect of the transaction is held to be the payment of a dividend. See, *e.g.*, *Commissioner* v. *Estate of Bedford*, 325 U.S. 283 (1945); *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967). Applying the strict net effect test in the way that the Government urges, in 1963, Taxpayer—because of the attribution rules of Section 318[6] of the Code—would be considered as owning all of the common stock of the Corporation so the distribution to him in payment for his preferred stock was made pro rata on his common stock. The Government contends that a pro rata distribution by a corporation effecting no basic change in shareholder relationships is the hallmark of a dividend, therefore the payment to Taxpayer was "essentially equivalent to a dividend" and taxable as such. *Himmel* v. *Commissioner*, 388 F. 2d 815 (2d Cir. 1964); *Kerr* v. *Commissioner*, 326 F. 2d 225 (9th Cir. 1964) cert. denied 377 U.S. 963.

The District Court, however, looked to the entire transaction and applied the "flexible net effect" test. Under

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[6] Section 318(a)(1) makes Taxpayer the constructive "owner" of the common stock owned by his spouse and children. Since his spouse and children each owned 25% of the remaining 75% of the common stock of the Corporation, Taxpayer winds up with 100% of the common stock. Section 318(a) is made applicable to Section 302 generally by Subsection (c)(1) of Section 302. But whether the attribution rules apply specifically to Section 302(b)(1) has caused some controversy. See, *e.g.*, Comment, 47 Minn. Law Rev. 853, 867-70 (1963). The District Court held that they do apply to Section 302(b)(1). We agree to the extent that constructive ownership of stock may be used as a factor to determine whether the distribution in question is in reality a dividend. See Treas. Reg. 1.302-2(b). But, like the flexibility given to the strict net effect test, there may be situations where it would be unrealistic to apply the attribution rules in strict fashion, for instance in cases of family estrangement. *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967); *Himmel* v. *Commissioner*, 338 F. 2d 815 (2d Cir. 1964).

this test, a business purpose for the redemption will temper the conclusiveness of a strict net effect result. See *Keefe* v. *Cote*, 213 F. 2d 651 (1st Cir. 1954). The Court looked to the point in time when Taxpayer contributed the $25,000 and found that the Corporation had always intended to redeem Taxpayer's preferred stock when the loan was paid off. We are aware that use of "business purpose" to mollify the rigors of the strict net effect test has been criticized, see, *e.g.*, *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967), even by the First Circuit which purports to follow it. *Bradbury* v. *Commissioner*, 298 F. 2d 111 (1st Cir. 1962). Many courts, however, give it some weight. See *United States* v. *Fewell*, 255 F. 2d 496 (5th Cir. 1958); *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (10th Cir. 1966); *Phelps* v. *Commissioner*, 247 F. 2d 156 (9th Cir. 1957); *Colvin* v. *United States*, 175 F. Supp. 877 (S.D. Cal. 1959); *Estate of Golwynne*, 26 T.C. 1209 (1956). In any event, the "strict net effect" test and the "flexible net effect" test complement each other in this respect: to the extent that the facts show a business purpose for the redemption there is an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates. See *Ballenger* v. *United States*, 301 F. 2d 192, 198 (4th Cir. 1962).

The Government concedes that there would be no issue of dividend equivalency here had the Corporation redeemed Taxpayer's preferred stock while Bradley owned fifty percent of the Corporation's common stock. A redemption of any of Taxpayer's preferred stock at such time would not have been a pro rata distribution on the Corporation's common stock. Nevertheless, armed with the strict net effect test the Government contends that Taxpayer's subsequent acquisition by way of attribution under Section 318(a) of the Code of one hundred percent control of the Corporation converted the distribution to him in payment for his preferred stock into a dividend paid pro rata on the common stock. To expand upon the Government's argument, Taxpayer was precluded from withdrawing his $25,000 investment intact because his decision to buy out Bradley's interest and acquire control of the Corporation converted what would have been

a straight stock redemption into a tax-avoidance scheme to bail out corporate earnings. We do not believe Congress intended that Section 302 of the Code should work such a harsh result especially since the primary purpose of capital gains treatment is to encourage individuals to risk capital for investment purposes. Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme.

A transaction involving Section 306 of the Code illustrates the converse situation. Under that Section, preferred stock or its equivalent is treated for income tax purposes as a cash dividend where the preferred stock was originally distributed as a stock dividend pro rata on the outstanding common stock. Section 306(c)(1)(A) Internal Revenue Code of 1954. Under Section 305 of the Code stock dividends are not taxable. When Section 306 preferred stock is sold or redeemed, the payment for it is taxable at ordinary income rates unless the shareholder has at the same time terminated his interest in the corporation.[7] Before the enactment of Section 306, the use of the "preferred stock bail out" was a popular tax avoidance device and Section 306 was intended to eliminate it. Section 306 stock, however, does not lose its cash dividend character if the holder disposes of all or part of his common stock. Section 302(b)(3); cf. *Himmel* v. *Commissioner*, 338 F. 2d 815 (2d Cir. 1964). Likewise, Taxpayer's preferred stock did not become a cash dividend coverup even if the attribution rules are applied from the date he bought Bradley's common stock.

The facts of this case demand that substance win over form and that the entire transaction control the tax effect of the stock redemption in issue. As the District Court stated:

> "The subsequent acquisition of Bradley's stock holdings by taxpayer, making the redemption distribu-

[7] Section 306 adopts the termination criterion of Section 302(b)(3) of the Code. See footnote 5, supra.

> tion essentially pro rata because of the § 318(a) attribution rules, neither impairs the legitimacy of the purpose underlying the issuance of the preferred stock [to provide additional security required by RFC] nor alters the fact that the redemption was simply the final [contemplated] step taken in completion of this purpose."

We conclude that the District Court was, under the facts and circumstances in this case, correct in holding that the redemption by the Corporation of Taxpayer's preferred stock was a distribution made in exchange for his stock and not a distribution that was "essentially equivalent" to a dividend.

Affirmed.

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 18,487

MACLIN P. DAVIS AND EDITH U. DAVIS,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges*, and MCALLISTER, *Senior Circuit Judge.*

JUDGMENT

Appeal from the United States District Court for the Middle District of Tennessee

This cause came on to be heard on the record from the United States District Court for the Middle District of Tennessee and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

It is further ordered that Plaintiff-Appellee recover from Defendant-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

CARL W. REUSS
Clerk

Filed March 27, 1969.

SUPREME COURT OF THE UNITED STATES

No. 282, October Term, 1969

UNITED STATES, PETITIONER

v.

MACLIN P. DAVIS, ET UX.

ORDER ALLOWING CERTIORARI—Filed October 13, 1969

The petition herein for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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